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Overview of recent economic developments and selected policy issues in the Economic Commission for Europe region: current economic situation in the ECE region[1]

I. Introduction

1. The negative effects of the financial crises in Asia in 1997 and the Russian Federation in 1998 were still depressing real economic activity in much of the Economic Commission for Europe (ECE) region, including international trade, until the early months of 1999. Fears that the world economy might slide into recession receded as stability was restored to the international financial markets, helped to a large degree by the temporary loosening of monetary policy in the United States, harsh adjustment measures in Asia and other developing countries, the costs of which were borne more by the domestic populations rather than foreign investors, and by the continued strong growth of the United States economy, which was able to act as "importer of last resort" for the rest of the world.

2. By the middle of 1999, the situation in most parts of the world economy had stabilized and in the second half of the year business confidence, real activity and expectations for 2000 were all improving steadily. In Western Europe, economic growth received a strong boost from exports to the rest of the world, not least from the strong import demand of the United States economy, and by the third quarter gross domestic product (GDP) was rising at its highest annual rate since before the Asian crisis. In the transition economies of Central Europe, the worst effects of the Russian crisis were receding in the second half of 1999 and they were starting to benefit from the revival of domestic demand in Western Europe. In the Russian Federation, there was a significant recovery in output for the first time in a decade, and, although the extent to which the underlying factors provide a basis for sustainable growth over a longer period is uncertain, this has nevertheless had a positive effect on most other members of the Commonwealth of Independent States (CIS).

3. These widespread improvements in the economic situation are not reflected in the annual figures for performance in 1999, which for the most part show a marked deterioration on those for 1998, but they are seen in the quarterly and monthly indicators for late 1999 and early 2000, and above all in the current forecasts for 2000. For the first time since 1990, average GDP growth in Western Europe is likely to exceed 3 per cent; for the transition economies of Eastern Europe growth should return to an average of 4 per cent or more in 2000, and the Baltic economies should emerge from recession with an average growth rate of some 3 per cent. After a much better than expected outcome in 1999, growth is also likely to continue in the Russian Federation and the other CIS countries, although here the prospects are much more problematic and uncertain. This much improved outlook for the European economies is also set against a background of more optimistic forecasts for other parts of the world economy, not least for continuing growth in the United States, where although a slowdown is currently forecast GDP is still expected to increase by some 4 per cent in 2000.

4. However, it is important to stress two points. First, there is always a distribution of risk surrounding any forecast and although the present report assumes that the balance is now more favourable for growth in Europe this does not mean that the downside risks are negligible; the possibility of a crash in overvalued equity prices in the United States is a serious risk to the current outlook, and there are uncertainties over the course of oil prices and of monetary policy in the European Monetary Union (EMU). Second, not all the economies of the region enjoy the same prospects and there are especially large differences among the transition economies. In particular, much of South-East Europe is still beset by severe structural problems and the consequences of several armed conflicts, which have made the process of transition to a market economy much more difficult than in Central Europe. The fact is that for the past decade, these countries — the poorest in Europe — have continued to fall further behind both Western and Central Europe instead of catching up.[2] The slight improvements in the short-run outlook for many of them in 2000 will do little to alter this situation, which poses a constant, if unpredictable, threat to economic and political stability in the European region as a whole.

II. Market economies of Western Europe and North America

5. The economic prospects for Western Europe now appear to be better than at any time in the last decade. In the second half of 1999, the region finally shook off the sluggishness of activity which had marked 1998 and early 1999, and by the third quarter (and probably the fourth as well) GDP was growing at an annual rate of about 3.5 per cent. Exports to the rest of the world had helped the process of recovery earlier in the year, but given the high levels of interdependence of the European economies this quickly had multiplier effects on demand throughout most of the European Union (EU). Business and consumer confidence strengthened considerably. Monetary policy has been expansionary, and relatively low levels of interest rates have helped to boost consumer expenditure and investment. Rising levels of employment and gains in real income, boosted in some countries by rising asset values, have also supported confidence and consumer spending. Business fixed investment was also rising through 1999, with above average increases in machinery and equipment — better prospects for sales, lower costs of financing, better profits, and perhaps some stimulus from the need to prepare for the Year 2000 problem were the main influences behind this improvement.

6. The improvement in output led to rising levels of employment during the year, by some 1.5 per cent on average between the fourth quarters of 1998 and 1999. The level of unemployment in Western Europe has also fallen, from 9.1 per cent at the end of 1998 to 8.4 per cent in the last quarter of 1999 (9.6 per cent in the euro area). Nevertheless, unemployment remains the greatest blot on the West European economic landscape and the major challenge for policy makers. Despite a wide range of schemes to reduce joblessness among particular groups, the problem of youth unemployment remains acute (16.8 per cent in the EU at the end of 1999), and the long-term unemployed — nearly one half of total unemployment in the EU — have yet to benefit significantly from the cyclical upturn in activity.

7. Despite the rise in import prices in 1999 due to higher oil prices and the weakness of the euro, the impact on West European rates of inflation has been quite modest. Intense competition has forced some absorption of higher producer prices in lower margins, but there have also been offsetting price falls for other products and in services where liberalization has been important. Labour cost pressures also remain mild, and although the annual rate of inflation in the euro area in February 2000 was 2 per cent, the upper limit of the European Central Bank (ECB) target, most forecasters expect the impulse from higher import prices to die away during the coming months. The main problem of inflation for the euro area is more the dispersion of rates (1.5 per cent to 4.6 per cent in February 2000) within the euro area and the difficulty that this raises, in combination with divergent cyclical positions, for the ECB's "one-policy-fits-all".

8. Against this general improvement in the economic indicators, economic growth in Western Europe in 2000 is expected to average slightly more than 3 per cent, and with most of the revisions tending to raise rather than lower the national forecasts, the outcome could perhaps be closer to 3.5 per cent.

9. Nevertheless, one of the major concerns of analysts and policy makers in Western Europe has been the relatively weak performance of the European economies over the past decade in comparison with the United States economy, and the question being asked now is whether the "new economy" of the United States can be replicated in Europe. The contrast between the two sides of the Atlantic is highlighted by the fact that after eight years of sustained growth, the increase in United States GDP in 1999 was still double the West European average; at the same time, inflation was just 2.2 per cent, a fraction higher than the upper limit of the ECB target for the EMU, and unemployment was 4.2 per cent compared to 9.2 per cent in the EU (10 per cent in the euro area). It is this performance of the United States economy — combining sustained growth and low unemployment without boosting inflation — which has convinced many observers that there is something "new" about the United States economy, and policy makers in Europe, as demonstrated at the EU summit held at Lisbon in March 2000, are eager to adopt it themselves. The sense that the West European economies, on average,[3] have been performing less well than the United States is reflected more generally in the still fairly large difference in their levels of real income (GDP) per head. The process of convergence has been slowing down since the early 1960s, and by 1990 real incomes in Western Europe were some 35 per cent lower than in the United States. In the 1990s, Western Europe has actually fallen behind rather than continuing to close

the gap, albeit slowly. Thus the potential for Western Europe to "catch up" with the United States is still significant.[4]

III. What is the "new economy"?

10. The underlying argument for a "new economy" in the United States is that a microeconomic combination of new information technology and market liberalization has transformed the key macroeconomic relationships between the growth of output and productivity, inflation and employment. The increased mastery over information flows enables resources to be employed much more efficiently than in the past; competition has increased since consumers can compare prices over a much wider range of suppliers on the Internet; much more sophisticated stock control is possible with the new technologies, and thus by dampening swings in inventories the amplitude of the business cycle itself is reduced if not eliminated. Moreover, these developments, it is claimed, all tend to raise corporate profits and economic growth, and rising productivity growth in a highly competitive environment keeps inflation at bay. Taken together, these various elements are used to explain not only the macroeconomic performance of the United States over the last decade or so but also why the present level of stock prices should not be judged against traditional yardsticks of asset values.

11. Around these basic ideas there are a number of variations which essentially amount to the same thing: thus, the "new economy" is sometimes described as "information" or "knowledge" driven, or as "weightless" or "dematerialized". What these terms are attempting to encapsulate are two tendencies which are often related: first, that the value added to gross output ratio has risen and continues to rise in the industrial economies, i.e., the raw material content of manufactures, for example, is an ever smaller proportion of their final price; and second, there has been a major shift in the structure of output and employment from industry to services, so that the "new economy" is also referred to as "the service economy". This latter development is particularly significant because it emphasizes the relatively high labour-intensity of the "new economy" and therefore suggests the likelihood of increasing employment instead of the more apocalyptic predictions of the mass destruction of jobs by the new technologies.

12. However, these descriptions of the "new economy" as "weightless", "knowledge driven" or "service dominated" are essentially new labels for ideas and tendencies which have been around for a very long time. The decline in the materials intensity of GDP, as a result of technical change, rising incomes and shifting consumption patterns, has been long established and long recognized;[5] the shift to skill intensive activities was quickly recognized by trade economists trying to account for the Leontief paradox in the 1950s and 1960s;[6] and the expansion of the service and information sectors is also consistent with old dynamic theories of economic growth in which the division of labour becomes finer and more specialized.[7] Thus the suspicion arises that the "new" economy may not be so original after all, but it is still important to identify the key factors in the United States economy's success of the last few years.

13. Since the mid-1990s there has been a sharp acceleration in United States productivity growth, although it has been almost entirely due to the durables sector of manufacturing.[8] At the same time, there has been a major boom in fixed investment: in the eight years following the 1991 recession year, gross fixed capital formation rose by 75 per cent or 7.3 per cent a year. So one obvious reason why labour is more productive in the United States is that is has more and better capital to work with (the capital labour ratio has risen). But changes in labour productivity are also influenced by a host of other factors, such as technical change, organizational efficiency and economies of scale. This latter group of factors thus accounts for the change in output that cannot be directly attributed to changes in the combined services of capital and labour. In the traditional growth accounting framework the "residual"[9] is commonly known as total factor productivity or multifactor productivity. The interesting feature of the more rapid growth in labour productivity in the United States economy in recent years is that it does reflect to a large degree a stronger growth of total factor productivity rather than of capital intensity,[10] which points to a more general and efficient use of all resources in the economy.

14. Such growth accounting, however, is beset by a number of important and well-known conceptual difficulties, not the least of which is the existence of interaction effects between factor inputs, notably capital (which embodies technical change) and total factor productivity. It is therefore no surprise that in

fast growing industries, such as information technology, there tends to be strong growth not only in capital investment but also in both labour productivity and total factor productivity. The investment boom in the United States has been largely driven by the growth of business expenditures on information and communications technology. It is quite likely that the direct growth enhancing effects of such new capital goods on labour productivity may not be adequately captured by the traditional growth accounting methods, which would tend to exaggerate the improvement in total factor productivity.

15. In seeking the factors behind the United States investment boom, it should be recalled that fixed investment has traditionally fluctuated much more than in Western Europe. In the United States, investment was actually very weak in the second half of the 1980s — in 1991, it was only just over 2 per cent more than in 1985 — whereas in Europe it rose by more than one third over the same period. So, bearing also in mind that technical progress does not usually stop during slowdowns and recessions, there was a large catch-up to be made in the United States and this started quickly in 1992. Another key element of the investment recovery is that it has been stimulated by a large fall in the cost of capital goods, which has encouraged the increase in the capital-labour ratio and in the size of the capital stock desired by enterprises.[11] It is this rapid fall in the cost of the equipment embodying the new technology which is perhaps one of the most striking features of the United States economy in the last decade. All new technologies eventually fall in price as new entrants compete away the super-normal profits of the innovators, but the process appears to have been exceptionally rapid in the 1990s. Market liberalization and increased competition must have played a role in this, but processes of cumulative causation are also set in motion when innovations trigger relative price changes, which increase still further the demand for the innovations, which in turn leads to lower unit costs of production, and so on. For this process to occur, however, enterprises must have confident expectations about the future growth of output if they are not to be caught with expensive idle capacity on their hands in the event of an unexpected fall in demand. It is at this point that macroeconomic policy plays a crucial role. In the United States, the federal budget deficit has been eliminated, removing the costs of crowding out and leaving monetary policy as the dominant influence in guiding the economy. In so doing, the Federal Reserve has throughout the 1990s taken a very pragmatic view of its role, accepting that there is considerable uncertainty over estimates of potential output and capacity utilization, especially in an economy dominated by services,[12] and being prepared to "wait and see" before risking a premature tightening of policy. Had the Federal Reserve acted rigidly on the basis of the conventional estimate of a potential output growth of 2.3 per cent, the United States boom might well have been cut short some time ago.

16. What are the lessons for European policy makers from the United States experience of the last decade? The first is that given the sluggish rate of European investment in the 1990s[13] and given that technical progress continues anyway, there is clearly a potential for a significant level of catch-up investment in Europe, just as there was in the United States in the early 1990s. The second lesson is to ensure that the strengthening business expectations about growth prospects are not upset by a premature raising of interest rates or confusions about the likely course of monetary policy. Statements about the need to raise interest rates whenever output picks up — and without even reference to estimates of capacity utilization, however uncertain — will not encourage investment in capacity-increasing investment.[14] Western Europe is in a more disadvantageous position than the United States insofar as the ECB is not required to address the broader agenda of economic growth, price stability and "full" employment that is the responsibility of the Federal Reserve.

17. Finally, although information technology is a major element in the current wave of innovation, Governments should still be cautious about promoting the use of individual technologies or the development of particular skills. This is another variant of "picking winners", for which the record has not always been very impressive (recall the oversupply of chemists in the late 1950s and early 1960s). A more appropriate strategy for market economies might be to improve the general environment for business investment and innovation, and to raise significantly the basic levels of education for all school-leavers. The latter is especially important, not only for increasing the supply of qualified and flexible members of the labour force but also for reducing marginalization and income inequalities.

18. There are two problems, however, that Western Europe will have to face which differentiate its situation from the United States experience of the 1990s. First, the massive United States investment in fixed assets and new technology was financed despite the low domestic savings rate by large inflows of foreign capital. The West European economies in aggregate are now in current account surplus and so there is scope to supplement domestic savings with foreign capital, although it would not be desirable, even if possible, to go as far as the United States in this direction. Second, the long United States upswing was also assisted by the boom in stock prices, which fuelled domestic spending and lowered the cost of equity capital for enterprises. Nobody knows when the stock market will turn or how far it will fall, but long historical experience suggests that it is probable that West European Governments will have to deal with the consequences of a major adjustment before very long. It is possible that Europe might benefit from a flight from dollar assets, but this could be more than outweighed by financial instability and upward pressure on the euro. Nevertheless, if the risks[15] of a premature tightening of monetary policy and of a disruptive fall in stock prices can be avoided, Western Europe could be on the threshold of a period of sustained growth of 3 per cent or more, which would at last make significant inroads into the currently high levels of unemployment.

IV. Eastern Europe and the Commonwealth of Independent States

19. There are 27 member countries of the Economic Commission for Europe which since the early 1990s have been described as having "economies in transition", that is, they are in the process of transforming the institutions, incentive systems and economic structures of central planning into those appropriate to a market system of decentralized decision-making, largely by private agents. This is a massive and complex task, and very few of them have got anywhere near completing the process. The legacy of the command economy is still strong in many parts of the CIS, and in South-Eastern Europe the process has been set back by a series of external shocks and by the effects of the various wars in the area. But in general, the progress in institution-building and structural change has been considerable even if it varies greatly among individual countries. Nevertheless, while some of the leading reformers in Central Europe now have the capacity to handle such shocks with relative ease,[16] many other transition economies remain highly vulnerable to external shocks, as demonstrated by the Asian and Russian crises of 1997-1998 or the Kosovo conflict of 1999. Although the leading reformers are now, as a result of successful restructuring and integration with Western markets, more sensitive to changes in domestic demand in Western Europe — nearly three quarters of Eastern Europe's merchandise trade is now with the European Union and for most of them Germany is the largest single trading partner — they have succeeded in maintaining domestic demand and relatively high rates of GDP growth.

20. Economic growth slowed down very sharply in virtually all the transition economies at the beginning of last year and the outcomes were generally much lower than the forecasts made at the start of the year. Instead of growing by some 3 per cent, as forecast, Eastern Europe only managed 1.4 per cent, while the Baltics plunged into a sharp recession. Only the CIS moved in the opposite direction, partly under the influence of the Russian Federation, where GDP increased unexpectedly by more than 3 per cent when most of the forecasts, official and unofficial, had been predicting another large fall in output.

21. This weak performance in 1999 to a large extent reflected the carry-over from the second half of 1998 of the after-effects of the general turmoil created by the Asian and Russian crises, aggravated for some economies by the Kosovo crisis last spring and by the slowdown in West European import demand. The Russian crisis had particularly severe consequences for the Baltic economies with massive cuts in their exports to the Russian Federation, leading to a severe deterioration in output and employment. However, the unwinding of these various factors in the course of 1999 led to a marked improvement in Central Europe in the second half of the year and a more moderate one in the Baltic States. The recovery in Western Europe was particularly important for Central Europe, while for the Baltic countries stronger West European import demand was not sufficient to offset the losses in the CIS markets.[17] Economic growth in three of the leading reformers, however — Hungary, Poland and Slovenia — was least affected by the various shocks of

1998 and 1999: all three have reported rates of GDP growth for 1999 of more than 4 per cent. Despite their dependence on the EU market for their exports, domestic demand, consumption and investment, including construction in Hungary and Slovenia, remained strong, but more generally the performance of these countries reflects their economic "maturity" and the ability of their economic institutions to handle external shocks more easily.

22. The biggest surprise in 1999 was the recovery of output in the Russian Federation, GDP rising by over 3 per cent instead of an expected fall of 2.5 per cent. The factors behind this were the sharp rise in oil prices from the spring, which boosted profits and the Government's tax revenues, a real depreciation of the exchange rate by nearly 50 per cent since the August 1998 crisis and a fall in real wages. The latter two factors enabled local producers to win back a significant share of their domestic market. Although GDP is expected to rise again in 2000, it is still difficult to be confident about the outlook for the Russian Federation because of the lacunae in the institutional framework and the limited progress made in microeconomic restructuring. It remains to be seen whether the new Administration can take advantage of the breathing space provided by the windfall gains of 1999 to launch an effective and radical programme of structural reforms.

23. Nevertheless, the recovery in the Russian economy, together with higher world prices for oil and non-ferrous metals, had a favourable impact on the other members of the CIS, with output continuing to fall only in Ukraine and the Republic of Moldova.

24. The economies of South-East Europe were obviously greatly affected by the Kosovo conflict and its aftermath for much of the year, although the direct impact on the neighbouring economies appears to have been less than feared. Reconstruction work in Kosovo itself has helped to raise industrial production in the region as did the recovery in West European import demand. But Romania remained in severe recession (GDP falling over 3 per cent), and in Yugoslavia, with its infrastructure severely damaged by NATO bombing, GDP and industrial output are estimated to have fallen some 20 per cent and more. There was, however, modest growth in Bulgaria and the former Yugoslav Republic of Macedonia (just over 2.5 per cent), although in the former industry remains in severe recession.

25. Although some countries experienced periods of financial distress, capital flows into Eastern Europe generally held up well in the wake of the various crises of 1997-1999. In 1999, against a backdrop of improving conditions in the international capital markets, new debt was issued by many transition economies and foreign direct investment (FDI) was often quite buoyant. Thus, for many countries the financing of their current account deficits was not a problem. However, in several countries capital inflows slowed in 1999, causing exchange rates to depreciate and triggering sharp adjustments in current account balances, often with negative consequences for domestic economic activity. This was the case, for example, in the Republic of Moldova and Ukraine, the only two CIS members reporting negative growth in 1999. GDP also declined in Romania, which was unable to raise the private capital required by the International Monetary Fund (IMF) under its new "bailing in" policy, and it was forced to draw on already low reserves to avoid default. A number of countries facing financial constraints early in 1999 saw their current account deficits decrease during the course of the year, which together with FDI inflows related to privatizations facilitated new borrowing and left them with much improved financial positions by the end of the year. The situation in the Russian Federation was exceptional, with a large current account surplus feeding large capital outflows.

26. The setbacks to activity in the transition economies in 1999 checked the gradual improvement in employment that had taken place in the previous two years, and apart from Hungary and Slovenia as well as the Russian Federation and a few other members of the CIS, there was a general decline in the first three quarters of the year. In several countries in Eastern Europe, especially Poland, the fall in employment was also due to a more intense rate of industrial restructuring. Unemployment, already high at the start of the year, reached an average 14.6 per cent of the labour force in Eastern Europe by December, a total of roughly 7.6 million people. In the Baltic States, unemployment averaged just over 9 per cent at the end of 1999, compared with 7.3 per cent a year earlier. In the Russian Federation the unemployment rate (according to the International Labour Organization (ILO) definition) was just over 12 per cent at the end of the year, about a point lower than at the end of 1998.

27. The other setback last year was a general check to the decline in rates of inflation which had been under way for several years and had gathered momentum in 1998. The factors behind this — and the extent of the reversal — vary between countries, but the most important single reason was the external shock of the rise in commodity prices and the appreciation of the dollar against most currencies. Nevertheless, given the weak state of the labour market in most countries and the generally prudent stance of macroeconomic policies, this upturn in prices seems likely to be no more than a temporary setback to the process of lowering inflation rates.

28. With a recovery of output under way since the second half of last year and the prospect of a relatively strong recovery in Western Europe, growth in all the transition economies in 2000 is expected to average 3 per cent, with GDP in Eastern Europe rising 4 per cent. Hungary and Poland should again have the highest rates of expansion — 5 per cent or more — and depending on the rate of growth in Western Europe these forecasts could be raised. As mentioned already, the Russian economy remains fragile and vulnerable to any external shock, such as a sharp drop in the price of oil. Nevertheless, the Government is expecting growth of up to 2 per cent and some officials are forecasting more than that. All the other CIS countries expect a return to or an acceleration of growth in 2000, although some of these expectations are highly contingent (for example, on the avoidance of a debt crisis in Ukraine and on a major policy adjustment in the Republic of Moldova).

V. South-East Europe

29. It was mentioned above that only a small group of former command economies are approaching the state of "normal" market economies. One particular subset of transition economies that has lagged far behind in the process are the seven economies of South-East Europe.[18] Although these are not the only economies making slow progress, attention has been focused on them in the aftermath of the Kosovo conflict and by the subsequent efforts of the international community to draw up proposals for the economic regeneration of the region and thereby strengthen the prospects for peace and general stability in the area.

30. Although, as noted above, the direct impact of the Kosovo conflict was less than feared earlier in 1999, the damage was still significant and the economies of South-East Europe moved from modest GDP growth in 1998 (1.3 per cent) into recession (about -3 per cent). The improvement forecast for 2000 is largely a recovery from this recession rather than the first signs of sustained economic growth. The macroeconomic situation in most of these countries is still relatively fragile. In general, the main success has been in reducing inflation, in several cases to very low rates; but current account deficits have been large and persistent, with a consequent build-up of foreign debt, unemployment rates average nearly 17 per cent, much higher than in Central Europe, and in conjunction with widespread job insecurity and discontent with living standards, this makes it difficult to implement reforms that might worsen the social situation still further in the short term. Domestic investment remains weak and foreign investment is not attracted to the region in any significant quantity.

31. As the present report has emphasized above, however, all these negative features are a reflection of problems which are much more fundamental than macroeconomic imbalances.[19] The economic problems in South-East Europe are for the most part essentially those of underdevelopment, despite the fact that in terms of a number of indicators, such as education, they are much closer to Western Europe than the traditional group of developing countries. The problems of transition are additional to the development issue, and on top of both are the economic and political consequences of the Kosovo conflict. This is a highly complex mixture of problems, which has subjected these economies to much greater strain than those of Central Europe. In some of them (Albania, Bulgaria, Romania), the legacy of the command system was much harsher than elsewhere and there were none of the gradual reforms that occurred in Central Europe before 1989. The initial conditions were thus highly unfavourable: much of the capital stock was rendered economically non-viable by the collapse of the old regime and the opening of markets, while much of the institutional and social capital required to manage adjustment and the reallocation of resources was also destroyed or made redundant. This mixture of development problems, together with the shock of transition and institutional disorganization, greatly narrowed policy makers' room for manoeuvre. Policy errors were certainly made and vested interests also obstructed reforms, but the sheer scale of the problems facing the Governments of the region meant that the

probability of crises was bound to be high in the absence of sustained, well organized and targeted assistance from abroad. The failures and delays in reform cannot be easily dismissed as "a lack of political will"; often it was more a case of "political paralysis" or policy "gridlock".

32. Of course, it should be emphasized that the countries of South-East Europe differ as much between themselves as the group differs from Central Europe, if not more, although they all share some combination of the same set of problems: institution-building, political and economic; constitutional and security issues; macroeconomic stabilization; industrial restructuring; high unemployment; high and/or growing levels of foreign debt etc.

33. In discussing proposals for the economic revival of the region, it is important to stress the importance of "non-economic" factors with significant economic consequences. First of all, one of the consequences of the violent dissolution of former Yugoslavia is a continuing uncertainty and ambiguity over borders and the formal status of several geographical entities in the region. This is a major source of insecurity, and while it persists it diverts the attention and energy of Governments away from economic matters and creates a propitious environment for illegal activities and organized crime.[20] Second, many of the countries in the region are still preoccupied with basic constitutional issues, the creation of political systems and the rebuilding of the state (perhaps nowhere is this more important than in Albania and Bosnia and Herzegovina). Third, institutions need to be developed for handling social conflicts — these include an effective and honest judiciary, trade unions, democratic institutions, and all the other elements of civil society which encourage peaceful cooperation and strengthen the power of "voice" rather than provoking "exit". And fourth, the leitmotif of the above is the creation of a strong rule of law, both to secure individual rights and security within a predictable framework and to improve the conditions for market-based activity by defining and protecting property rights and enforcing laws of contract. Without significant progress in all of these areas, it will be extremely difficult, for example, to attract foreign investment to the region or to focus the energies of Governments on economic development. These various dimensions of the economic problems of South-East Europe are clearly recognized in the Stability Pact for South-Eastern Europe,[21] both in its title and in its creation of three "working tables", namely, for democratization and human rights; economic reconstruction, development and cooperation; and security issues.[22]

34. International efforts to assist the economies of South-East Europe are now extensive, but it is becoming increasingly clear that they suffer from many of the same problems that have beset the assistance efforts to most other transition economies ever since 1989. First, there is a large gap between promises to provide assistance and its actual disbursement — this delays action and creates disillusion in the region. Second, there is poor coordination between the 29 countries and international organizations belonging to the Stability Pact — resources are widely dispersed and inadequately coordinated both between donors and with national programmes.[23] Third, there is also a confusion of conceptual frameworks and approaches, and it is by no means obvious that the essential differences between the trio of problems — development, transition and post-war reconstruction — are clearly recognized. There is also a tendency for donors to promote separate projects without placing them within a broader programme of development, and sometimes projects reflect more the interests of their promoters than those of the recipient countries. The need for individual countries in South-East Europe to draw up their own programmes for transition and development, which would accurately reflect their specific problems and preferences, is one of the lessons which ECE has previously drawn from the highly successful Marshall Plan of the late 1940s.[24] These national programmes would then be discussed in a regional framework to improve coordination and encourage cooperation wherever there are international public goods, economies of scale and other externalities to be found.

35. The regional dimension is certainly important and for a number of reasons. The very fact of increased efforts at regional cooperation is a sign of increasing stability and security in the region, and as such an important step towards attracting foreign investment. But cooperation to remove trade barriers and other obstacles to doing business across the region would also help to overcome the difficulties of trying to attract FDI to a collection of small, low-income and fragmented markets. If foreign direct investors can envisage supplying a regional market instead, the incentives to invest in the region are greatly increased,

especially if the EU were to move quickly to remove all trade barriers to imports coming from South-East Europe.[25] Regional cooperation can also make it easier to deal with black markets, organized crime and other activities which are subversive of market and democratic institutions. The failure to deal effectively with these and other matters is one reason why some of the better placed countries in the region are more keen to disassociate themselves from "the Balkans" and seek directly closer bilateral links with the EU.

36. The importance of this regional dimension is clearly recognized by the EU, specifically in the Stability Pact, but the dimension of national programmes does not get similar emphasis.[26] Yet it was the integration of national programmes within a regional framework which was a crucial element in the effectiveness of the Marshall Plan, and it is difficult to see how regional cooperation can be effective if national programmes fail. This is underlined in the current situation by the current exclusion of Yugoslavia from the Stability Pact, although it is widely recognized that a programme for regional security and economic development cannot succeed unless it is included. Moreover, that success requires not only the participation of Yugoslavia in regional cooperation schemes but also the recovery of the Yugoslav economy itself. At present, the prospects for this are highly uncertain and largely dependent on political developments. Nevertheless, the maintenance of economic sanctions against Yugoslavia would appear to be counter-productive from the perspective of the economic objectives: they encourage rent-seeking and the concentration of wealth among the ruling elite in Yugoslavia, while leaving much of the population in an impoverished and vulnerable situation, and at the same time they encourage the very black market and other illegal activities that regional cooperation is trying to eliminate.

37. The problems and delays in getting an effective programme of assistance under way for the economies of South-East Europe have been widely aired in recent weeks, not least by senior officials of the European Commission and NATO, and by the heads of EU Governments at their summit meeting at Lisbon in March 2000. The Special Coordinator of the Stability Pact has complained about the delays in implementation and the gap between countries' commitments to provide funds and their actual delivery.[27] Nevertheless, an increased sense of urgency marked the Regional Funding Conference for South-East Europe in late March, and the amounts pledged (2.4 billion euros) were actually more than the stated requirements (1.8 billion euros). The emphasis on a "quick-start" package[28] (of 1.8 billion euros) for regional projects and initiatives[29] over the coming year and on projects that will make a visible difference to the lives of ordinary people is important for lifting expectations not least in the local business communities. The EU is to contribute 530 million euros to the quick-start package, which is to be matched by contributions by individual EU member States. This is to be the first instalment on a 12 billion euros six-year programme for the region. Within this long-term programme, 2.3 billion euros have been earmarked for Serbia, provided there is a change of leadership. Limited funding for Montenegro is also envisaged (although World Bank participation is not possible because it is not a sovereign state). The EU proposal to accelerate the liberalization of its imports from South-East Europe should provide an important boost in the same direction. But the problem of the slow disbursement of committed funds will have to be overcome — essentially by the donor countries — if expectations are not to take the opposite direction. The problem of coordinating national programmes of development still needs to be addressed, and although a quick start to many projects is crucially important there should be no illusions that the basic task — the economic regeneration of the region — can be accomplished quickly. For Western Europe and the EU in particular, the pursuit of economic regeneration and of stability and security in the region will have to be a long-term commitment.

Notes

[1] The present report is a reproduction of ECE, *Economic Survey of Europe, 2000*, No. 1, chap. 1; the ECE region consists of all the countries of Europe, the Commonwealth of Independent States, North America and Israel.

[2] See ECE, op. cit., chap. 5.

[3] The qualification is important because many of the smaller European economies have performed as well as the United States in many respects.

[4] For an extensive discussion of convergence, see ECE, op. cit., chap. 5.

[5] See A. Maizels, *Commodities in Crisis* (Oxford University Press, 1992), especially chap. 11.

[6] One framework for analysing the shift to "weightlessness" is Lary's breakdown of value added into four classes of relative factor intensity. Activities in the modern or "new" economy are increasingly concentrated into his "skilled-labour intensive" category. See H. Lary, *Imports of Manufactures from Less Developed Countries* (New York, Columbia University Press, 1966).

[7] See A. Young, "Increasing returns and economic progress", *The Economic Journal*, vol. 38, December 1928; and P. Rayment, "Intra-industry specialization and the foreign trade of industrial countries", in S. Frowen ed., *Controlling Industrial Economies* (London, Macmillan, 1983).

[8] See ECE, op. cit., chap. 2.2(b).

[9] M. Abramovitz coined the term "residual of our ignorance" because it measures the change in output that cannot not be attributed to other quantifiable factors impinging on economic activity.

[10] See D. Sichel, "Computers and aggregate economic growth: an update", *Business Economics* (Washington, D.C.).

[11] The relative price of computer equipment in the United States fell by nearly 50 per cent between 1990 and 1999; see ECE, op. cit., chap. 2.2(b).

[12] Direct estimates of capacity utilization still only refer to industry; in much of the services sector, estimates of capacity use are much more nebulous.

[13] In the six years following the 1993 trough in Western Europe, gross fixed capital formation increased 24 per cent or 3.7 per cent a year, which is considerably weaker than recovery in the United States in the six years following the 1991 trough there.

[14] According to investment surveys much of the fixed investment in Western Europe in the 1990s was for raising efficiency (rationalization) rather than extending capacity; this is a reminder that labour productivity raising technical change can be associated with either the same output being produced by fewer workers or to a larger output being produced by a less than proportionate *increase* in labour input. The former is closer to the West European experience of the 1990s, the latter to the United States.

[15] See ECE, op. cit., chap. 2.2(iv).

[16] Ibid., chap. 3.2.

[17] Due to the specific commodity composition of these countries' exports the actual shift of exports to Western Europe was slower than anticipated but it became more evident later in the year; see ECE, op. cit., chap. 4.2(i).

[18] See ECE, op. cit., table 3.1.1, for a definition of the group used here.

[19] See, "Postwar reconstruction and development in south-east Europe", in ECE, *Economic Survey of Europe*, 1999, No. 2.

[20] See A. Politi, "The new dimensions of organized crime in south-eastern Europe", *The International Spectator*, vol. XXXIV, No. 4 (October-December 1999).

[21] In his speech to the South-Eastern Europe Regional Funding Conference at Brussels on 29 March 2000, Mr. Patten, responsible for External Relations of the European Commission, said "That is what the Stability Pact is about — a recognition that the problems of the region have to be tackled in the round; a recognition that coping with crisis after crisis is far more costly than implementing a long-term strategy for peace". Accessed at European Commission web site (europe.eu.int).

[22] The Pact was agreed at Cologne on 10 June 1999 and signed by heads of Government at a Summit held at Sarajevo on 30 July 1999. The procedure is for each table to draw up a list of priorities and work plans. Participants in each table are entitled to introduce initiatives provided that they are accompanied by concrete cost and financing plans. The Pact envisages a broad participation of nations, including Yugoslavia, but on the condition that the present regime is no longer in power. The Republic of Montenegro (a constituent republic of Yugoslavia) has been invited to attend stability pact meetings and will benefit from specific projects. The Stability Pact itself does not include an independent source of funding. Financing for proposed projects and programmes is to be mobilized on a case-by-case basis from bilateral and multilateral sources.

[23] This is also the conclusion of a report prepared by the European Commission, as reported in *Financial Times*, 23 March 2000. The President of the European Commission has also warned that "fragmented initiatives and multiple decision-making will not deliver lasting peace, redevelopment and stable growth"; see R. Prodi, "EU must bring peace to the Balkans", *International Herald Tribune*, 21 March 2000.

[24] ECE, *Economic Survey of Europe in 1989-1990*, chap. 1, and *Economic Survey of Europe*, 1999, No. 2, chap. 1.

[25] Liberalization in the other direction should be delayed, however, for infant industry reasons, preferably for a clearly specified period.

[26] "We need a coherent policy for the whole area rather than separate policies for each country"; see R. Prodi, loc. cit. "My job is to encourage regional cooperation which helps those who help themselves and which fosters the process of Europeanization ... we are not equipped economically or conceptually or in terms of programmes to be involved in their internal affairs"; see B. Hombach, quoted in "Knocking heads together to bring prosperity to the Balkans", *Financial Times*, 25 February 2000.

[27] See *Financial Times*, 25 February 2000.

[28] For projects likely to be started or tended during the 12 months to 31 March 2001.

[29] Regional infrastructure projects to be identified by the EIB should amount to 1.1 billion euros and private sector development projects identified by the EBRD another 290 million euros.

Table 1

Annual changes in real GDP in Western Europe and North America, 1997-2000

(Percentage change over previous year)

	1997	1998	1999[a]	2000[b]
Western Europe	2.8	2.7	2.0	3.2
4 major countries	2.1	2.3	1.9	2.9
France	2.0	3.4	2.7	3.5
Germany	1.5	2.2	1.5	2.8
Italy	1.8	1.5	1.4	2.5
United Kingdom	3.5	2.2	2.0	3.0
18 smaller countries	4.1	3.4	2.4	3.5
Austria	1.2	2.9	2.2	2.8
Belgium	3.5	2.7	2.3	3.2
Cyprus	2.5	5.0	4.5	4.1
Denmark	3.1	2.7	1.3	2.0
Finland	6.3	5.0	3.5	4.5
Greece	3.4	3.7	3.3	3.7
Iceland	5.3	5.1	6.0	2.9
Ireland	10.7	8.9	8.3	7.5
Israel	2.9	2.2	2.0	3.5
Luxembourg	7.3	5.0	5.1	4.3
Malta	4.8	3.1	4.8	4.8
Netherlands	3.8	3.7	3.5	3.5
Norway	4.3	2.1	0.8	2.7
Portugal	3.5	3.5	3.1	3.3
Spain	3.8	4.0	3.7	3.7
Sweden	2.0	3.0	3.8	4.0
Switzerland	1.7	2.1	1.7	2.5
Turkey	7.5	2.8	-2.3	4.6
North America	4.5	4.2	4.1	4.0
Canada	4.0	3.1	4.2	3.9
United States	4.5	4.3	4.1	4.0
Total above	3.6	3.4	3.1	3.6
Japan	1.6	-2.5	0.3	0.7
Total above, *including Japan*	3.3	2.5	2.6	3.1
Memorandum items:				
European Union	2.6	2.7	2.3	3.1
Euro area	2.3	2.8	2.3	3.1

Source: OECD national accounts, national statistics and national economic reports.

Note: All aggregates exclude Israel. Growth rates of regional aggregates have been calculated as weighted averages of growth rates in individual countries. Weights were derived from 1991 GDP data converted from national currency units into dollars using purchasing power parities.

[a] Preliminary estimates or forecasts.

[b] Forecasts.

Table 2

Basic economic indicators for the ECE transition economies, 1997-2000

(Rates of change and shares, per cent)

	GDP (growth rates)					Industrial output (growth rates)			Inflation (per cent change, Dec./Dec.)				Unemployment rate (end of period, per cent)		
			1999												
	1997	1998	Ex-ante forecast	Actual	2000 official forecast	1997	1998	1999	1997	1998	1999	2000 official forecast[a]	1997	1998	1999
Eastern Europe	2.1	1.8	2.9	1.4	4	4.9	0.8	-0.2	..	..	..	..	11.9	12.6	14.6
Albania	-7.0	8	8	8	8	2.8	21.8	16.0	42.0	7.8	-1.0	3	14.9	17.6	..
Bosnia and Herzegovina[b]	..	..	..	..	12	35.7	23.8	10.6	12.2	2.2	-0.4	..	39*	38.5	39.1
Bulgaria	-7.0	3.5	3.7	2.6	4	-10.0	-12.7	-12.5	578.7	0.9	6.2	2.8	13.7	12.2	16.0
Croatia	6.8	2.5	1.5-2	-0.3	2.6	6.8	3.7	-1.4	4.0	5.6	4.6	2-3	17.6	18.6	20.8
Czech Republic	-1.0	-2.2	-0.8	-0.2	1.5	4.5	1.6	-3.1	9.9	6.7	2.5	3.3-4.4	5.2	7.5	9.4
Hungary	4.6	4.9	5	4.5	5	11.1	12.5	10.5	18.4	10.4	11.3	6-7	10.4	9.1	9.6
Poland	6.9	4.8	4.5	4.1	5.2	11.5	3.5	4.4	13.2	8.5	9.9	5.7	10.3	10.4	13.0
Romania	-6.1	-5.4	-2	-3.2	1.3	-7.2	-16.8	-8.0	151.7	40.7	54.9	25-30	8.8	10.3	11.5
Slovakia	6.5	4.4	3	1.9	2	2.7	3.8	-3.4	6.5	5.5	14.4	14.1	12.5	15.6	19.2
Slovenia	4.6	3.9	4	4.9	3¾	1.0	3.7	-0.5	8.8	6.6	8.1	4-5	14.8	14.6	13.0
The former Yugoslav Republic of Macedonia	1.4	2.9	6	2.7	6	1.6	4.5	-2.6	4.5	-1.0	2.4	..	41.7	41.4	47
Yugoslavia[c]	7.4	2.5	7	-19.3	14	9.5	3.6	-23.1	10.3	45.7	54.0	–	25.6	27.2	27.4
Baltic states	8.4	4.5	4.5	-1.7	3	8.2	5.6	-8.2	..	..	..	..	6.3	7.3	9.1
Estonia	10.6	4.0	4	-1.4	3.8-4.0	14.6	2.3	-3.9	12.3	6.8	3.9	4.0	4.6	5.1	6.7
Latvia	8.6	3.9	4	0.1	3.5	13.8	3.1	-8.8	7.0	2.8	3.3	3.0	6.7	9.2	9.1
Lithuania	7.3	5.1	5	-3.0	2	3.3	8.2	-9.9	8.5	2.4	0.3	4.1	6.7	6.9	10.0
CIS	1.1	-3.0	-1.1	2.9	2¼	2.5	-3.0	7.2	..	..	..	..	7.6	9.0	8.4
Armenia	3.3	7.2	4	3.0	5.6	8.2	-2.7	5.2	21.8	-1.2	2.1	10	11.0	8.9	11.5
Azerbaijan	5.8	10.0	9	7.4	8	0.3	2.2	3.6	0.3	-7.6	-0.5	..	1.3	1.4	1.2
Belarus	11.4	8.4	4-6	3.4	2-3	18.8	12.4	9.9	63.4	181.6	251.3	60	2.8	2.3	2.0
Georgia	11.3	2.9	8	3.0	4.2-4.8	8.2	-2.7	4.8	7.3	10.8	11.1	..	8.0	4.2	5.6
Kazakhstan	1.7	-1.9	1.5	1.7	3	4.1	-2.4	2.2	11.3	1.9	18.1	7.1	3.9	3.7	3.9
Kyrgyzstan	9.9	2.1	2.8	3.6	4-5	39.7	5.3	-1.7	14.7	18.3	39.8	20	3.1	3.1	3.0
Republic of Moldova[d]	1.6	-8.6	-3	-4.4	2	–	-15.0	-9.0	11.1	18.2	43.8	15	1.7	1.9	2.1
Russian Federation	0.9	-4.9	-2.5	3.2	1.5-2.5	2.0	-5.2	8.1	11.0	84.5	36.7	18*	11.2	13.3	12.3
Tajikistan	1.7	5.3	..	3.7	..	-2.0	8.2	5.0	159.9	2.7	30.1	..	2.8	2.9	3.1
Turkmenistan	-11.4	5.0	..	16.0	12	-32.3	0.2	15.0	21.5	19.8	..	..	..	..	..
Ukraine	-3.0	-1.7	-1	-0.4	1	-0.3	-1.0	4.3	10.1	20.0	19.2	19	2.8	4.3	4.3
Uzbekistan	5.2	4.4	4.4	4.4	5	4.1	5.8	6.1	27.5	25.9	..	..	0.3	0.4	0.5
Total above	1.6	-1.1	0.7	2¼	3	3.7	-1.2	3.6	..	..	..	..			
Memorandum items:				..											
CETE-5	4.5	3.2	3.6	3.1	4.1	8.4	4.5	2.8	..	..	..	..	9.8	10.2	12.5
SETE-7	-3.4	-1.6	1.3	-2.9	3.6	-3.9	-9.7	-10.0	..	..	..	..	14.3	15.4	16.6
Former GDR	1.7	2.0	..	..	..	7.0	7.6	4.8	2.3	1.1	0.2	..	19.4	17.4	17.7

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to ECE secretariat.

Note: Aggregates are ECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exceptions of the Russian Federation, where it is the Goskomstat estimate according to the ILO definition, and Estonia where it refers to job seekers). Aggregates shown are: *Eastern Europe* (the 12 countries below that line), with sub-aggregates *CETE-5* (Central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and *SETE-7* (South-East European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, the former Yugoslav Republic of Macedonia and Yugoslavia); *Baltic States* (Estonia, Latvia, Lithuania); and *CIS* (12 member countries of the Commonwealth of Independent States).

[a] Annual averages unless otherwise indicated.

[b] Data reported by the Statistical Office of the Federation; these exclude the area of Republika Srpska.

[c] The unemployment rate in 1999 excludes Kosovo and Metohia.

[d] Excluding Transdniestria.

* December/December.

Table 3

International trade and external balances of the ECE transition economies, 1997-1999

(Rates of change and shares, per cent)

	Merchandise exports in dollars (growth rates)			*Merchandise imports in dollars (growth rates)*			*Trade balances (per cent of GDP)*			*Current account (per cent of GDP)*		
	1997	1998	1999[a]	1997	1998	1999[a]	1997	1998	1999[a]	1997	1998	1999[a]
Eastern Europe[b]	6.4	9.3	-0.8	6.5	9.0	-2.2	-10.4	-10.0	-9.7	-4.3	-4.6	-5.5
Albania	-35.6	50.9	28.3	-32.1	28.2	11.3	-21.1	-19.2	-17.2	-11.9	-1.5	-4.3
Bosnia and Herzegovina	232.1	82.7	47.3	29.2	36.4	14.7	-40.8	-42.0	-42.5	-31.7	-26.1	..
Bulgaria	1.0	-15.1	-5.6	-2.8	0.5	9.9	0.1	-6.2	-12.3	4.2	-0.5	-5.5
Croatia	-7.6	8.9	-6.0	16.9	-7.9	-7.2	-24.3	-17.7	-17.4	-11.5	-7.1	-7.2
Czech Republic	2.7	15.7	1.9	-1.3	4.4	0.3	-9.1	-4.4	-3.8	-6.1	-2.4	-2.0
Hungary	21.6	20.4	8.7	17.0	21.1	9.0	-4.7	-5.7	-6.1	-2.1	-4.9	-4.3
Poland	5.4	2.6	-3.1	13.9	10.9	-2.5	-11.6	-12.0	-12.0	-3.0	-4.4	-7.5
Romania	4.3	-1.5	2.4	-1.4	4.9	-12.2	-8.1	-8.5	-5.5	-6.1	-7.2	-3.8
Slovakia	0.2	11.8	-4.9	-8.0	11.9	-13.5	-10.2	-11.0	-5.3	-10.0	-10.1	-5.7
Slovenia	0.7	8.1	-5.6	-0.6	7.8	-1.4	-5.5	-5.4	-7.2	0.2	–	-3.0
The former Yugoslav Republic of Macedonia	2.8	11.0	-11.5	7.8	9.0	-8.8	-15.5	-17.2	-17.0	-7.5	-8.2	-4.1
Yugoslavia	45.0	6.8	-47.2	17.3	0.5	-30.5	-10.9	-11.9	-10.4	-9.3	-10.2	..
Baltic states	23.1	3.5	-12.6	26.7	7.5	-13.9	-21.9	-22.4	-18.7	-9.5	-11.1	-9.6
Estonia	41.1	10.3	-9.2	37.4	7.8	-14.0	-32.5	-29.8	-23.1	-12.2	-9.2	-4.9
Latvia	15.9	8.3	-4.9	17.4	17.1	-7.6	-18.6	-21.5	-18.4	-6.1	-11.1	-12.1
Lithuania	15.1	-3.9	-19.3	23.8	2.6	-17.3	-18.6	-19.4	-16.9	-10.2	-12.1	-10.3
CIS[c]	0.8	-15.2	-9.0	8.5	-14.1	-32.6	5.2	6.0	13.5	-0.4	-1.4	6.7
Armenia	-19.9	-5.2	-2.2	4.3	1.1	-8.4	-40.4	-36.0	-32.8	-18.8	-20.6	-14.7
Azerbaijan	23.8	-22.4	21.9	-17.3	35.6	-1.2	-0.3	-11.4	-10.8	-23.1	-33.1	-25.4
Belarus	29.2	-3.2	-19.5	25.2	-1.6	-28.7	-10.4	-12.9	-5.1	-5.9	-7.5	-0.4
Georgia	20.5	-19.7	12.4	37.3	-6.3	-35.4	-14.2	-14.1	-13.7	-7.6	-8.5	-0.5
Kazakhstan	9.9	-17.8	-16.0	1.4	-1.4	-22.4	9.9	5.0	9.3	-3.6	-5.4	-3.4
Kyrgyzstan	19.6	-15.0	-10.2	-15.4	18.7	-28.8	-5.9	-20.5	-8.4	-7.8	-23.2	-12.1
Republic of Moldova	10.1	-27.8	-40.3	9.3	-12.6	-52.9	-15.4	-23.1	-9.8	-14.8	-20.4	-1.2
Russian Federation	-0.3	-16.3	-8.2	13.1	-17.9	-40.7	7.7	10.3	20.7	0.9	0.7	11.2
Tajikistan	-3.1	-20.0	20.3	12.3	-5.2	-11.5	-0.4	-8.7	3.2	-6.1	-8.1	-7.5
Turkmenistan	-55.3	-20.9	102.3	17.0	-14.9	25.9	-16.1	-15.1	-1.1	-21.6	-34.2	-24.4
Ukraine	-1.2	-11.2	-13.7	-2.7	-14.3	-25.1	-5.8	-4.9	-0.8	-2.7	-3.1	3.3
Uzbekistan[d]	-4.4	-20.1	3.8	-11.2	-25.4	3.3	-1.1	0.7	0.1	-4.0	-0.3	-2.4
Total above[b]	3.9	-3.5	-5.6	8.1	0.3	-14.4	-1.5	-2.7	-0.2	-2.1	-3.2	-0.2
Memorandum items:												
CETE-5	6.8	11.6	0.6	6.7	11.1	-0.6	-9.5	-9.1	-8.8	-3.7	-4.2	-5.6
SETE-7[b]	4.7	0.2	-7.2	6.0	2.3	-8.0	-13.0	-12.7	-12.4	-6.4	-6.0	-5.1

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to ECE secretariat; IMF; ECE secretariat calculations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Current-price GDP values for 1999 are in some cases estimated from reported real growth rates and consumer price indices. For regional aggregates, see ECE, *Economic Survey of Europe, 2000*, No. 1, note to table 3.1.1.

[a] Full year for eastern Europe and Baltic states; January-September for CIS countries and for the aggregate "Total above". Current account balances for the Baltic States are based on extrapolations of January-September trends (see ECE, op. cit., table 4.1.1).

[b] Aggregates of current account balances exclude Bosnia and Herzegovina and Yugoslavia.

[c] Including intra-CIS trade.

[d] 1999 trade data are based on Interfax Agency, *Statistical Report*, 20 January 2000.

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Regional cooperation

Summary of the economic and social situation in Africa, 1999

1. The present document, based on the *Economic Report on Africa 2000*, prepared by the Economic Commission for Africa (ECA), reviews the economic and social conditions prevalent in Africa at the dawn of the twenty-first century. Focusing first on the economic performance of the continent and its subregions, it then identifies a set of initial conditions from which policy implications are derived. It finally puts forward a set of indices to measure the long-term sustainability and macroeconomic performance of the African economies.

I. Africa's economic performance

2. Africa's economy grew an estimated 3.2 per cent in 1999, barely improving the previous year's modest performance of 3.1 per cent. Africa's annual average economic growth of 2.1 per cent during the last decade of the twentieth century did not keep pace with the yearly increase in population of 2.8 per cent and was considerably lower than the 7 per cent annual growth rate required to reduce poverty by half by the year 2015. The slow growth of the African economy is the biggest obstacle to improving the living conditions of the majority of Africans.

3. Encouraging results are recorded at the country level. In sharp contrast to previous experience, no African country posted negative GDP growth in 1999. Furthermore, only one economy grew at a rate of less than 1 per cent, compared to four in the previous year. In 19 countries the growth rates ranged between 1 and 2.9 per cent, while another 17 countries managed to grow in the 3-4.9-per-cent range; 12 countries had growth rates between 5 and 6.9 per cent. Five countries, as opposed to only two in the previous year, grew at a rate higher than 7 per cent in 1999. Growing at an estimated 10 per cent each, Mozambique and Equatorial Guinea had the strongest economic performance.

4. At the subregional level, East and Southern Africa, which account for 45 per cent of the population and 37 per cent of the region's GDP, enjoyed higher growth in 1999 relative to 1998. The other three subregions, which together account for 55 and 63 per cent of the population and GDP, respectively, experienced lower rates of growth. East Africa pushed up the aggregate growth rate from the 2.6 per cent of 1998 to 4.1 per cent in 1999, while Southern Africa improved its performance from 1.7 to 2.2 per cent. In North Africa the average growth declined from 4.4 per cent to 3.6 per cent. Performance declined from 3.6 to 3.3 per cent and from 5 to 4.5 per cent in West and Central Africa, respectively.

5. The five largest economies in Africa (i.e., the African G-5) — Algeria, Egypt, Morocco, Nigeria and South Africa — which account for 59 per cent of GDP and 37 per cent of the population of the region, posted a growth rate of 2.8 per cent in 1999. The 11 oil-exporting African economies, which account for 49 per

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cent of the region's GDP and 41 per cent of the population, marginally improved their 1998 growth rate, by 0.1 percentage point, to reach 3.7 per cent in 1999. The six island economies, making up about 2 per cent of the region's GDP and population, posted a decline in their rate of growth from 4.6 per cent in 1998 to 4.0 per cent in 1999. The least developed African countries, representing 16.5 per cent of the GDP and 47 per cent of the population, have shown dynamic GDP growth rates in excess of the continental average in recent years. They again succeeded in increasing the previous year's growth rate by 0.2 percentage points, to reach 4.5 per cent in 1999. The 15 landlocked countries (10 per cent of the regional GDP and 23 per cent of the population) managed to increase their growth rate from 4.2 per cent in 1998 to 4.9 per cent in 1999.

6. At the sectoral level, growth rates declined in agriculture (from 3.5 per cent in 1998 to 2.1 per cent in 1999) and in the industrial sector (from 3.2 to 2.8 per cent). On the other hand, the growth rate in the service sector increased by 1 percentage point, to reach 4 per cent in 1999.

7. Agricultural performance in 1999 was mixed across the region. In North Africa, growth in agriculture decelerated, while in West Africa it increased. Performance in Central Africa was restrained due to civil unrest, political instability, and pest infestation; output in East and Southern Africa declined as a result of a erratic rainfall, war, and uncontrolled crop pests. The poor performance of agriculture, aggravated by population displacement due to political instability, has exposed nearly 20 million people to critical food shortages, requiring emergency food assistance.

8. The service sector continues to be dynamic, showing a 4.0-per-cent growth rate in 1999 relative to only 3 per cent in 1998. Although all service subsectors are growing, the financial and communications services are the lead performers.

9. The terms of trade declined by nearly 6 per cent as a result of a fall in the unit value of exports by more than 3 per cent and an increase in the unit price of imports by more than 2 per cent. The increase in the value of African exports (in United States dollar terms) by 2.4 per cent was due to a 6-per-cent increase in the volume of goods exported, which more than offset the decrease in the unit price of exports. Imports also increased in value and volume. While the increase in value was on the order of 4 per cent, the volume of imports increased by 1.4 per cent.

10. The balance of trade registered export earnings of $101 billion in 1999, an increase of 2.4 per cent from 1998. The current account balance deteriorated further, increasing to $21 billion in 1999, a 13-per-cent increase from 1998.

11. External resource flows rose from $16 billion in 1998 to $22 billion in 1999. Foreign direct investment amounted to about $6 billion while $7 billion came in as transfers. Borrowing amounted to $8.4 billion, an increase of nearly 45 per cent over 1998. The volume of debt rose from $351 billion of 1998 to $359 billion in 1999. Debt servicing increased from $35.7 billion in 1998 to $39.4 in 1999.

II. Initial conditions for development

12. Africa enters the twenty-first century as the poorest and least developed region of the world, the most technologically backward, the most indebted, and the most ravaged by civil conflicts. Half of Africa's population lives in poverty, on an average of $0.83 per person per day. Malnutrition, disease, inadequate housing and unemployment are rampant. Any attempt to relocate the region on a dynamic, shock-resistant, poverty-reducing growth trajectory needs to take into account the constraints imposed by income, poverty and inequality, economic structure, investment, institutions of governance and the state of human capital.

13. Africa accounts for 12.5 per cent of the world's population but produces only 3.7 of the global GDP. Even though it exports no less than a fifth of its GDP annually, it accounts for no more than 1.5 per cent of the global trade in goods and services. In 1999, Africa's 799 million people produced goods and services worth $525 billion in real terms. This amounts to a per capita income of $688 per annum. Yet, at the country level, per capita GDP varies between a high of $6,100 for Seychelles to a low of $100 for Mozambique.

14. At the subregional level, the highest GDP is recorded in North Africa, at $215.6 billion and a per capita annual income of $1,264, followed by that of Southern Africa, at $157.4 billion and per capita of $1,388. Central Africa has the lowest GDP, at

$27.4 billion, but its per capita income is $937. The lowest per capita income is recorded for East Africa, at $177 and a GDP of $42.2 billion.

15. In addition to low levels of income, Africa also exhibits highly unequal distribution of income, with a Gini coefficient of 44.4 per cent. The richest 20 per cent of the African population receive 51 per cent of total expenditure, while the poorest 20 per cent receive only 5 per cent.

16. Although poverty is endemic both in the rural and urban settings, it is more widespread and severe in the former. In sub-Saharan Africa, 59 per cent of the rural population lives below a poverty line of $31.67 per person per month. The average income of the rural poor is estimated at $14.22 per person per month, or $0.47 per person per day, less than half of the internationally accepted minimum of $1 per person per day. Over 43 per cent of the urban population lives below the poverty line of $69 per person per month.

17. Highly unequal distribution of expenditure also characterizes the rural sector of Africa, with a Gini coefficient of 48 per cent. The lowest 40 per cent of the rural population accounts for 16 per cent of total expenditure, while the top 20 per cent receives 48 per cent.

18. Inequality is also prevalent in urban Africa, which has a Gini coefficient of 50 per cent. The lowest 40 per cent of the urban population commands only 16 per cent of total expenditure, while the top 20 per cent accounts for 50 per cent of total expenditure.

19. Over the past four decades, African economies experienced a structural shift. The share of agriculture in GDP declined from 40 per cent during the decade of the 1960s to 21 per cent at the end of the century. However, the decrease in the share of agriculture in GDP by nearly 50 per cent was not due to significant growth of the industrial sector. The share of industry increased marginally from 26 per cent to 30 per cent of GDP during the intervening decades, while the share of the manufacturing industries increased from 9 per cent in the 1960s to 15 per cent at the end of the century. It was the service sector, whose share of GDP increased from 34 per cent to 50 per cent, that benefited the most from the decline in agriculture.

20. The predominance of the service sector in the economies of African countries at the current stage of their development is indicative of a distorted transformation. It has been estimated that the current employment and output shares of the service sector in Africa correspond to a real per capita income level between $2,441 and $4,024, which is considerably higher than the continent's real average per capita income (in 1985 terms) of $1,503 in 1999.

21. A real per capita GDP of $5,224 can be used as a benchmark to determine whether an economy has achieved a relatively mature productive structure. How quickly will Africa achieve this status? At its present rate of growth, the target income level can be achieved only after five and a half decades. To reduce the time period, Africa would need to increase its growth rate significantly. The fact that Mauritius achieved the required level of income in 1988 and that Seychelles will do so shortly shows that, with some systematic effort, African countries could transform themselves into mature industrial economies.

22. One of the most important determinants of long-run growth is investment. Africa is still undercapitalized, given its growth requirements. The required investment to enable a GDP growth rate of 7 per cent per annum for the whole continent is about 33 per cent of GDP, compared to a current investment rate of about 20 per cent of GDP. For sub-Saharan Africa the investment gap is larger: 17 per cent of GDP versus the required 40 per cent.

23. Economic growth does not occur in a vacuum. Countries need social and political institutions that secure rights of private property and personal liberty; enforce contracts; provide stable, responsive, honest, transparent and accountable governments; and allow for social and geographic mobility. At the minimum, peace and political stability are a basic prerequisite for orderly economic activity to take place.

24. Although the move towards freedom and democracy that occurred in the past decade was unprecedented, African countries tend to be the least free in the world, with repressive regimes still common and democracy still fragile. Twenty-three out of the 50 countries classified as "not free" by the Freedom House index are African. Using that index, the continent as a whole is only "partly free" but shows considerable improvement in political liberties and civil rights over the early 1990s. The Southern Africa subregion is the freest, with 52.1 per cent of the population of the subregion living in countries classified as "free". In West Africa only 8 per cent of

the population live in "free" countries, while in East Africa most people live in "partly free" countries. In Central Africa, 15.9 per cent of the people live in "partly free" countries and 83.6 per cent live in "not free" countries. North Africa is the only subregion with an overall "not free" status.

25. War and civil conflicts have affected 61 per cent of the African population since 1963. East Africa was the region with the highest percentage of affected population (79.4 per cent), followed by Central Africa (73 per cent), West Africa (64 per cent) and North Africa (51 per cent). Southern Africa recorded the lowest share of affected population (29 per cent).

26. Of the 26 conflicts reported by the Organization of African Unity (OAU), seven are inter-State, arising from border disputes and territorial claims related to disagreement over the interpretation of colonial legal documents. The remaining 19 conflicts are classified as internal. Some of the identified causes for conflict are destabilization by mercenaries, human rights violations, geopolitics and cold war, ethnic disputes, power-sharing, and inter-clan rivalries and other factional rivalries and their contagion. Poorer countries are shown to have a considerably higher risk of civil war than richer countries: because of poverty, young men and women have little to lose when they join the rebel armies.

27. In addition to war and civil conflict, Africa also suffers from a population that is neither healthy nor sufficiently schooled. More than 23 million Africans live with HIV/AIDS; almost 14 million have died already. With more than 70 per cent of the world's total number of people living with HIV/AIDS, Africa's economy is being seriously threatened by the pandemic. It is estimated that over the next 20 years, if unchecked, HIV/AIDS will reduce the economies of sub-Saharan Africa by a fourth.

28. As a result of AIDS, the life expectancy of Africans has been reduced by as much as 20 years in some hard-hit countries, wiping out the gains achieved over the past few decades. Infant mortality rates are higher due to AIDS, reversing the progress made in infant and child survival in many countries. In East and Southern Africa, infant mortality rates are nearly 70 per cent higher than what they might have been without AIDS. The scourge is also having a significant impact on businesses by increasing expenditures and reducing income. Business expenditures are increased by health-care costs, burial fees and replacement of employees, while revenue is decreased by absenteeism due to illness, caring for the ill, attending funerals and time spent on training new employees. Studies show that profits have decreased from 20 to 7 per cent as a direct result of HIV/AIDS. The annual cost of HIV/AIDS to a firm ranges from $17 to $300 per worker.

29. Other preventable diseases are all too prevalent. Malaria and tuberculosis further strain the already depleted health budgets. Chronic protein-energy and micronutrient malnutrition affects a large proportion of women and children, resulting in anaemia, blindness and chronic fatigue which can exacerbate diarrhoea, respiratory infections, and measles. The health disadvantages of African countries have a negative impact on wages and productivity. Improving the health status of the African population could be one of the most effective ways to contribute to economic growth.

30. The technological base of the continent is another binding initial condition, as is the brain drain. Africa accounts for only 1 per cent of the total research and development funds and the patents for new products worldwide. African countries do not have enough absorptive capacity; many countries graduate university students who immediately join the ranks of the unemployed. Thousands of African doctors, engineers and scientists leave the continent to search for better opportunities elsewhere.

III. Policy implications

31. Given the current low performance of the continent and the constraints imposed by the initial conditions outlined above, it is perhaps important to ask what development policies might bring about a transformation. Following a long period of experimentation, the policy community seems to be gravitating towards a consensus. In the historical, socio-cultural and economic context of most African countries, reliance on market forces alone is not sufficient; development must be based on broader principles. The Comprehensive Development Framework advocated by the World Bank is a good example of the new consensus. Africa's development strategy should be based on and target the fundamentals summarized below.

A. Participatory approach

32. Key stakeholders must be involved in formulation of the strategies and identification of the actions that need to be undertaken. All the parties concerned should be mobilized to participate in — and thus "own" — the development strategy.

B. Broad-based and equitable growth

33. A key requirement for Africa's development is growth — the dynamic, equitable, and sustained growth necessary to reduce poverty and raise the living standards of the population. The growth strategy should foster the private sector as the principal engine of growth. Africa's private investors require lower transaction costs and less uncertainty.

C. Savings and investment

34. High and sustained growth rates in Africa would require substantial increases in investment and productivity. New investment should support more productive technologies and higher skill levels. Domestic savings must improve and be invested in plant and equipment instead of in real estate or idle land. African economies must attract foreign savings and reverse capital flight trends by reducing risk and increasing returns. Key measures include a stable macroeconomic environment, an efficient, well-regulated financial sector, effective rule of law, protection of property rights, contract enforcement and, good governance.

D. Investment in human capital

35. The economic and social transformation of Africa in the next millennium will not occur without increased investment in health and education. Low levels of investment in those sectors are major impediments to growth and development. The shares of government budgets to the two sectors must be increased. Investment in health should focus on prevention and basic services and not on funding expensive, highly equipped hospitals. Investment in education should emphasize primary and secondary education, without undermining advanced training in order to prepare for competition in knowledge-intensive sectors. The emphasis should be on increasing the quantity and quality of the services and the efficiency of resource use and equity in their provision.

E. Technological development

36. African Governments should establish incentives for firms to adopt and master new technologies and other modern practices and to engage in entrepreneurship, innovation and learning. This will entail a symbiotic relationship between government, the private sector and institutions of higher learning.

F. Trade and industrialization strategy

37. The required economic and social transformation cannot occur unless the vicious circle of dependence on primary commodities, raw materials and unskilled labour is broken. Countries need to identify, support and expand activities where value-added is greater, productivity growth is faster, and demand elasticities in world markets are higher. Selective governmental intervention in industrial development is inevitable. The diversification of the production and export sectors which is required for Africa's development in the next century is not possible without protection of infant industries. Countries must identify strategic sectors that require protection and then define and identify benchmarks, terms and conditions under which the incentives will be provided.

G. Agriculture and rural development

38. The strategy for rural development should be an essential part of a broader strategy for poverty reduction. Removing the distortions in the incentives structure is not enough and has not elicited the expected supply response. The strategy for agricultural development should go beyond "getting the prices right" and focus more on increasing the productivity of the sector by removing institutional and structural constraints. Policies should aim at increasing public investment in agricultural research and infrastructure and at increasing farmers' skills and access to credit. New technologies, appropriate to the natural conditions of different regions in Africa, should be adopted.

H. Environmental protection

39. Effective environmental policies are essential at the national and regional levels. Environmental deterioration has increased in the past decade due to a number of factors, including increased poverty, high population growth, pressure on scarce resources and environmentally unfriendly reforms. African Governments need to address the underlying causes of

environmental degradation, including market failures, poor information, and pernicious incentives. There is need to promote local solutions based on an analysis of costs and benefits and in consultation with all stakeholders.

I. Integration into the global economy

40. Any improvement in African economic performance will depend on the extent to which the continent becomes integrated into the world economy. African economies must expand their markets, diversify, and become competitive. One way to diversify might be to develop common infrastructures such as transport and communications, banking and insurance services.

J. Aid and external debt

41. Africa's development will continue to be dominated by aid and debt in the foreseeable future. Since the conditions that were largely responsible for the ineffectiveness of official development assistance (ODA) are improving and given the development challenges for the twenty-first Century, the need for ODA is even greater. At the same time, Africa's development partners should continue to look for ways to help resolve the debt burden.

K. Institutional infrastructure and good governance

42. An important element of Africa's development effort has been the move towards a market economy, but the benefits in terms of higher growth and poverty reduction have been limited. Transformation will weaken some of the existing institutional arrangements, while creating the need for new ones. In order to manage the change that will come with development, it is important to strengthen the institutional infrastructure and, where necessary, establish new institutions.

L. Role of governments and public policy

43. Perhaps the most important challenge arising from the foregoing discussion is the critical role that African Governments will have to play in ensuring that the region will achieve the social and economic transformation that is required for development in the next millennium. It is important to recognize that even in a completely private market economy, Governments will be required to manage the rules and regulations that govern the functioning of a market economy. At the core of a market economy are transactions, which are governed by property rights and contracts. To ensure an even playing field, Governments must effectively and equitably monitor and enforce the rules and regulations. Strengthened administrative and managerial capacities in the public sector will allow Governments to provide the necessary leadership and help the development of the private sector through teaching by doing.

IV. Economic sustainability and policy stance indices

44. The Economic Sustainability Index (ESI) is a comprehensive indicator of economic sustainability that measures an economy's capacity to produce outcomes that are consistent with long-term structural change on a regular basis. ESI assesses a country's medium- to long-term potential to produce and maintain good economic performance by focusing on indicators of sustained growth, human capital, structural diversification, transaction costs, external dependency, and macroeconomic stability. Each country is given a score between 1 and 10, on the basis of how it compares with the average of the three best performers in Africa.

45. ESI scores reveal that the sustainability of African countries is low. Only a fifth of the continent's population lives in economically sustainable countries while half of Africa's population resides in countries with low degrees of sustainability The most sustainable economies (in descending order) are those of Seychelles, Tunisia, Egypt, South Africa, Mauritius, Morocco, Botswana, Lesotho, Swaziland, and Algeria. The 10 least sustainable countries are (in ascending order): Sierra Leone, Chad, Niger, Guinea-Bissau, Burundi, Central African Republic, Uganda, Ethiopia, Mali, and Democratic Republic of the Congo.

46. At the sub-regional level, North Africa has the highest ESI score — 5.79. Southern Africa is second, with a score of 4.20. Central Africa and West Africa are next, with 3.44 and 3.20, respectively. With a score of 3.12 East Africa has the lowest ESI..

47. To see how sustainability has changed in the recent past, an ESI for the year 1987 was constructed and compared to that for 1999. The progress made is

encouraging. Overall, Africa's ESI improved by 4.8 per cent. While 26 countries registered positive changes in their ESI, 18 countries managed increases of more than 10 per cent. In contrast, only seven countries (Comoros, Angola, Sierra Leone, Rwanda, Gabon, Democratic Republic of the Congo, and Zambia) experienced a decline of more than 10 per cent in their ESI. At the subregional level, West Africa showed the highest improvement (12.3 per cent) over the intervening period, followed by North Africa (7.8 per cent), and East Africa (4.3 per cent). Southern and Central Africa suffered declines of 6.9 per cent and 2.8 per cent, respectively.

48. The countries that showed substantial improvement are of all sizes, regions, and levels of development, showing that the potential exists for all African countries to make progress towards a more sustainable future. Most of the best performers benefited from cessation of civil wars, greater stability, and economic and political reforms. In contrast, almost all of the bad performers suffered from serious civil conflict and unrest during the period under consideration. Peace, stability, and deepening economic and political reforms are necessary conditions for Africa's sustainable development during the twenty-first century. Furthermore, the components of ESI — sustained growth, human capital, structural diversification, transaction costs, external dependency and macroeconomic stability — are correlated with each other. Particularly striking is the strong correlation between human capital and all other components of ESI. This implies that countries with a better human capital stock stand a better chance of sustaining positive developmental outcomes.

49. The Economic Policy Stance Index (EPSI) analyses macroeconomic policies of African countries, including fiscal, monetary, and exchange rate policies. Countries score from 1 to 10 on the basis of how they compare with the continent's best performers. Kenya earns the top score, bolstered by strong performance across the board. Ethiopia comes second, having made significant progress towards liberalization in recent years. South Africa, Gabon and Namibia round out the top five. Sao Tome and Principe, Malawi, Central African Republic, Angola, and Sierra Leone are the lowest scorers. Civil conflict and economic mismanagement appear to be explanatory factors for the low performance. East Africa comes out ahead, with a score of 5.84, followed by North Africa (5.81) and Southern Africa (5.57). Central Africa scored 5.19, while West Africa placed last, with a score of 5.04.

50. According to EPSI, 37.3 per cent of the African population live in countries implementing good macroeconomic policies; while only 29.8 per cent live with bad macroeconomic policies.

51. The quantitative analysis of EPSI have been combined with the results of a survey of qualitative nature conducted by ECA, using a questionnaire filled out by a sample drawn from a variety of occupational groupings across the continent, including representatives from government, business, international organizations, non-governmental organizations, and academia. Governmental officials tended to have the highest degree of confidence in their countries' economic policies. Members of the business community were next, which bodes well for Africa's future competitiveness, suggesting that policy makers are making serious attempts to facilitate a business-friendly environment. Conversely, representatives of non-governmental organizations gave the worst scores of any of the occupational categories.